Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills: See Legislative History | Telephone: 845-7814 | Introduced Date: February 22, 2007

Attorney: Douglas Powers | Sponsor:

SUBJECT: Research Expense Credit/Increase Amount

SUMMARY

This bill would increase the amount of the Qualified Research Expense Credit.

PURPOSE OF THE BILL

It appears the intent of this bill is to encourage businesses to increase their research and development programs.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit in the amount of 20% of the excess qualified research expenses. The research credit is designed to encourage companies to increase research and development activities.

Board Position:			Department Director	Date
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To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be incurred in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new or improved business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

The federal credit does not apply to any expenses paid or incurred after December 31, 2007.

California conforms to the federal credit with the following modifications:

- ♦ The state credit is not combined with other business credits.
- ♦ Research must be conducted in California.
- ♦ The credit percentage for qualified research expenses in California is 15% versus the 20% federal credit.
- ♦ The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- ♦ The California alternative incremental research expense credit (AIRC) rates are 1.49%, 1.98%, and 2.48% versus the federal rates of 3%, 4%, and 5%, respectively.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent without regard to whether the federal credit is operative.

THIS BILL

This bill would raise the credit for increasing qualified research expenses from 15% to 20% for taxable years beginning on or after January 1, 2007.

This bill would also fully conform to the federal AIRC for taxable years beginning on or after January 1, 2007.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill could be accomplished during the department's normal annual updates.

LEGISLATIVE HISTORY

SB 359 (Runner, 2007/2008) would, among other things, increase the Qualified Research Expense Credit from 15% to 16% and conform to the federal AIRC. SB 359 is currently in the Senate Revenue and Taxation Committee.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the Qualified Research Expense Credit from 15% to 18%. AB 2032 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the Qualified Research Expense Credit to the amount allowed at the federal level. AB 2567 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the originating house by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

PROGRAM BACKGROUND

The department annually releases a report on state tax expenditures. The 2006 State Tax Expenditure Report contains information regarding the usage of the Research Expense Credit, a copy of which is attached as Appendix A.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain "eligible costs" for renewable energy technologies investment. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6 ½% of the qualifying expenditures.

Massachusetts allows corporate taxpayers to claim an income tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15% of the basic research payments and 10% of qualified research expenses conducted in *Massachusetts*.

Minnesota allows corporate taxpayers a credit equal to 5% for qualified research expenses up to $2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first $2 million.

Michigan allows corporate taxpayers a credit for pharmaceutical research and for a percentage of the compensation for services paid by the taxpayer that is engaged in research and development of a hybrid system for propelling motor vehicles. An eligible taxpayer may claim a credit against the Single Business Tax equal to 6.5% of the excess of qualified research expenses paid in the tax year that relate to pharmaceutical-based business activity in *Michigan* paid during the three immediately preceding tax years.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18% of the cost of research and development property, 9% of the qualified research expenses, or the costs of high-technology training expenditures paid by the taxpayer. The credit is limited to $250,000 per taxable year.

FISCAL IMPACT

The bill would not impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 751 Operative for Tax Years BOA January 1, 2007 Enacted by June 1, 2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Increased Qualified Research Expense Credit	-$125	-$160	-$170	-$175
Increased AIRC rates	-$5	-$6	-$5	-$5
Total	-$130	-$166	-$175	-$180

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact for this bill was estimated as follows: First, the revenue loss due to an increased in the Qualified Research Expense Credit rate was estimated using corporate credit samples from Franchise Tax Board for tax years 2001-04. For each corporation in the sample of corporate tax returns, the tax liabilities under the current and proposed laws were simulated taking into account the entity's taxable income, net operating losses, qualified research expenses, the Qualified Research Expense Credit rates, and carryover credits. Because taxpayers without sufficient tax liabilities would be unable to use the additional credit in the year it was generated, unused credit would be carried forward to subsequent years. The unused corporate Qualified Research Expense Credit is currently in excess of $8 billion. Using the department's tax model, results have shown that the proposed increased Qualified Research Expense Credit rate would generate $580 million additional credit in 2004. However, the tax model showed that only $115 million of this amount could be used in reducing tax liability for the same tax year. The AIRC currently accounts for about 2% of the Qualified Research Expense Credit claimed. The percentage increases in the AIRC rates under this bill are more than that of the Qualified Research Expense Credit rate. Therefore, it is assumed that the revenue loss due to higher AIRC rates would be about 4% of the loss from increased Qualified Research Expense Credit rate.

Next, the results were expanded from the sample to the corporate population and extrapolated to later years. The extrapolation was based upon the latest Department Of Finance forecast for corporate profits.

Finally, personal income tax revenue impact in future years as a fraction of the corporate revenue impact is assumed to be equal to the ratio of personal income tax Research Expense Credits to corporate Research Expense Credits in 2004. This ratio in 2004 was 6%.

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Appendix A

The California R&D credit is a credit that normally is taken in conjunction with the Federal Research Credit. The calculation of the amount of research expenses creditable in California generally conforms to the calculation for federal purposes, with the exception that the California credit only applies to research activities conducted in California.

At the federal level, there are two reasons to encourage R&D. The first is that, without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities;" i.e. benefits to people other than the person doing the R&D. The federal R&D credit reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity. Since state R&D credits also reduce the after-tax cost of R&D, they too will induce an increase in the overall level of R&D spending. The second purpose of the federal R&D credit is to encourage taxpayers to do their R&D in the United States, rather than in another country.

Since the structure of the California R&D credit generally conforms to that of the federal credit, the California credit will produce both of these same effects. It will contribute to an overall increase in R&D activity, and it will encourage R&D activity to be undertaken in California rather than elsewhere. Because California's contribution to total R&D spending is smaller than the federal government's contribution, the first effect – global increases in R&D activity -- is somewhat less important to state policy than to federal policy. The second effect -- regional competition -- is a relatively more important motivator for state policy. This is because it may be easier for some R&D firms to move their activity to another state than it would be for them to move it to another country, and many states besides California offer R&D credit. Therefore, a California credit may be 19 necessary for the state to remain competitive with these other states in attracting and maintaining research business activity.

Both effects of the California R&D credit, the increase in the overall amount of R&D activity, and the increase in the proportion of this activity that takes place in California, must be considered in evaluating the success of the California R&D credit. The desirability of the increase in overall R&D activity is dependent on the level of the federal R&D credit (and credits offered by other states and countries). If the federal credit is too low, the added R&D incentives provided by states collectively could generate productive additional R&D activity. Alternatively, if the federal credit has already induced optimal levels of R&D, any increases in overall R&D spending induced by additional state credits will be inefficient and hurt overall economic performance. It is not known whether the federal R&D credit is currently set at the optimal level.

The R&D credit may be viewed as successfully maintaining the competitiveness of the California R&D industry only if R&D activity is undertaken in California that would not have been undertaken here in the absence of the credit. The amount of R&D activity that would not have taken place in California in the absence of the credit is unknown. Credits granted for R&D that would have occurred even in the absence of the credit may be considered a windfall.

There are two possible benefits to attracting the R&D business to California. The first is the addition of the R&D jobs themselves. If this were the only benefit, the R&D industry should be singled out for this special benefit only if jobs in this industry are substantially more desirable than jobs in other industries in the state. The second potential benefit from bringing R&D to California is that other California businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many California businesses, not just those receiving this credit, will gain an advantage over their rivals in other states. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and without cost. The advantage to California may come through something economists call *economies of agglomeration. Economies of agglomeration* are defined as “a reduction in production costs that results when firms in the same or related industries locate near one another.”

Thus, for example, if the R&D credit encourages some pharmaceutical companies to locate their research facilities in an area of California, that will, likewise, encourage the growth of pharmaceutical research support firms (such as material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, chemical engineers) to be attracted to that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silicon Valley and motion pictures in Hollywood are two obvious examples). However, many factors contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which the California R&D 20 credit has actually encouraged the development or growth of any agglomeration economies is not known.

We also note that less than one-third of this credit is actually available to reduce tax in the year that it is generated. The inability to use the credit (because of a lack of tax to reduce) undoubtedly reduces the incentive provided by the existence of the credit.